Supreme Court, U.S.
FILED

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No.

IN THE
Supreme Court of the United States.
OCTOBER TERM, 1996.

SOUTH DIVISION CREDIT UNION,
Plaintiff/Respondent,

v.

DOROTHY McFARLAND,
Defendant/Petitioner.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

PETITION FOR WRIT OF CERTIORARI.

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QUESTIONS PRESENTED FOR REVIEW

Whether the elements of a nondischargeability case pursuant to § 523(a)(2)(B) of the Bankruptcy Code require proof that the debtor's false financial statement was the proximate cause of damages or detriment to the creditor.

Whether a false financial statement under which a debtor procures new money also makes other money lent by that creditor to the debtor nondischargeable under § 523(a)(2)(B), even though that other money was not procured by means of the false financial statement.

LIST OF THE PARTIES

The names of all of the parties in the proceeding appear in the caption of this case and on the cover of this petition.

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GROUNDS ON WHICH JURISDICTION OF THE UNITED STATES SUPREME COURT IS INVOKED

This is an appeal of a judgment entered May 23, 1996 by the United States Court of Appeals for the Seventh Circuit, reversing the judgment of the United States District Court for the Northern District of Illinois, Eastern Division dated March 10, 1995, affirming a decision of the United States Bankruptcy Court dated June 15, 1994. After remand, judgment was entered in the District Court, consistent with the judgment of the Court of Appeals, on July 10, 1996.

Certiorari is sought in accordance with 28 U.S.C. § 1254(1) and the United States Supreme Court Rules 10(a) and (c).

CONSTITUTIONAL AND STATUTORY PROVISIONS

11 U.S.C. § 523(a)(2)(A),(B)

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual from any debt --

. . .

(2) for money, property, or services, or an extension, renewal, or refinancing of credit, to the extent obtained, by --

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing --

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive;

. . .

STATEMENT OF THE CASE

Statement of Facts

Dorothy McFarland was a long-time customer of South Division Credit Union (SDCU) who had taken out a number of loans and always kept them current. On or about May 6, 1993, Ms. McFarland applied for a new loan in the amount of $3,500 in order to fix her roof. On her credit application for the new loan, Ms. McFarland neglected to list two debts: one to the IRS in the amount of $1,500.00, and the second to Overland Bond Co. in the amount of $7,000.00. The latter was a loan taken out by her brother for which Ms. McFarland had co-signed but had never paid.

Upon review of the application, SDCU agreed to lend Ms. McFarland the amount requested. SDCU claims that under its policies, had it known of the omitted debts, it would not have agreed to lend the $3,500.00, because Ms. McFarland's debt-to-income

ratio exceeded SDCU's allowed maximum of 45 per cent.

When the new loan was made, SDCU also loaned Ms. McFarland enough money to pay off a previous loan, marked the old promissory note "paid in full", and issued a new promissory note for the amount remaining on the old loan, plus the amount of the new loan. This repayment was required by SDCU policy, even though Ms. McFarland had not applied to refinance the balance of her old loan, because SDCU would not allow a customer to hold two outstanding loans at the same time.

The balance of the previous loan was $5,757.17 and was scheduled to mature on February 28, 1995. With the addition of the new money, the new balance was $9,257.17, and was scheduled to mature on May 1, 1998. There was no relevant change in the interest rate

or in the collection remedies associated with the new loan.

Course of Proceedings

Ms. McFarland filed a voluntary chapter 7 bankruptcy petition on September 8, 1993. At that time, she owed SDCU $8,712.28 on the consolidated loans. She listed SDCU as an unsecured creditor in her bankruptcy schedules.

SDCU filed a nondischargeability complaint against Ms. McFarland in the Bankruptcy Court under 11 U.S.C. § 523(a)(2)(B), claiming that the entire amount of the loan was non-dischargeable because Ms. McFarland had omitted material facts when she had applied for the new money.

After trial, the bankruptcy court found that only the new money portion of the note was nondischargeable and thus entered a nondischargeability

judgment only to the extent of $3,500. It further found that the balance of the debt had not been advanced due to any false statement of Ms. McFarland. The district court also found that Ms. McFarland had only obtained $3500 based on her false statements and therefore affirmed. The Court of Appeals reversed and held that since there is no statutory requirement of detriment or damage to the creditor, the entire debt is nondischargeable.

Jurisdiction in the Court of First Instance

The Bankruptcy Court had jurisdiction under 28 U.S.C. § 157(a) and (b)(2)(J),(O), 28 U.S.C. § 1334 and 11 U.S.C. § 523(a) together with an order of reference entered by the District Court of the Northern District of Illinois pursuant to its authority under 28 U.S.C. § 157(a).

ARGUMENT

Section 727(b) of the Bankruptcy Code requires the court to grant a chapter 7 discharge unless the debt is considered nondischargeable under section 523. Because the goal of bankruptcy is to provide the debtor with a fresh start, the exceptions to discharge are generally construed narrowly against the creditor and liberally in favor of the debtor.[1] The burden is on the creditor to prove by the preponderance of the evidence that the debt fits squarely within the statutory framework. Section 523(a)(2) excepts from discharge money, property, services, or credit to the extent that they were obtained by oral or written misrepresentations. Section 523(a)(2)(B) states the

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[1] See Gleason v. Thaw, 236 U.S. 558, 35 S.Ct. 287, 59 L.Ed. 717 (1915) (based on the purposes of the bankruptcy law, "exceptions to discharge ... should be confined to those plainly expressed").

conditions that must be met in order to find a debt nondischargeable based on a false financial statement:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual from any debt --

...

(2) for money, property, or services, or an extension, renewal, or refinancing of credit, to the extent obtained, by --

...

(B) use of a statement in writing -

(i) that is materially false;
(ii) respecting the debtor's or an insider's financial condition;
(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
(iv) that the debtor caused to be made or published with intent to deceive.

I. THERE IS A SPLIT AMONG THE CIRCUITS ON WHETHER THE CREDITOR'S RELIANCE ON THE FALSE STATEMENT MUST HAVE BEEN THE PROXIMATE CAUSE OF ITS LOSS IN ORDER TO RENDER A DEBT NONDISCHARGEABLE UNDER 11 U.S.C. 523(a)(2)(B).

This case, like Field vs. Mans, - U.S. -, 116 S.Ct. 437, 133 L.Ed. 2d 351 (1995) involves a split in the

Circuits concerning the appropriate elements of a cause of action for nondischargeability under the Bankruptcy Code. In Field, this Court delineated the elements of a claim for nondischargeability for fraud under 11 U.S.C. § 523(a)(2)(A).[2] This case involves a split in the Circuits on the elements of a case for nondischargeability based on a false financial statement under § 523(a)(2)(B).

On one side of the issue, two Courts of Appeals have held that a proximate cause and detriment requirement is inherent in 523(a)(2)(B). These courts conclude that the section read as a whole requires that damage to the creditor was proximately caused by the debtor's false financial statement. In re Siriani, 967 F.2d 302, 306 (9th Cir. 1992) ("[the creditor] had to show that the fraud proximately caused its loss by adducing

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[2] The Court held that justifiable reliance is required as an element of a case for fraud under § 523(a)(2)(A).

evidence that it relied on the financial statements, that it had valuable collection remedies at the time of renewal, and that such remedies lost value during the renewal period"); In re Collins, 946 F.2d 815, 816 (11th Cir. 1991)(the debtor "correctly asserts that there is a causation requirement implied in the exception to discharge provided in § 523(a)(2)(B)"). See also 3 Collier on Bankruptcy ¶523.10 at 523-64 (15th ed. 1996) ("If the creditor does not forfeit remedies or otherwise rely to his or her detriment on a false financial statement with respect to existing credit, then an extension or renewal, or refinancing of such credit is nondischargeable only to the extent of the new money advanced").

These cases are consistent with the jurisprudence of fraud and with basic tort law outside bankruptcy.[3] In

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[3] W. Keeton, D. Dobbs, R. Keeton, & D. Owen, *Prosser* (continued...)

addition, numerous other courts have interpreted Code § 523(a)(2)(B) to include a causation requirement.[4]

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[3](...continued)
and Keeton on Torts, § 105, p. 728 (5th Ed. 1984) (stating that the elements of the tort of misrepresentation include "damage to the plaintiff, resulting from ... reliance"). In chapter 7 of the same book, the authors discuss the central importance of causation in tort law. They state "[a]n essential element of the plaintiff's cause of action for negligence, or for that matter for any other tort, is that there be some reasonable connection between the act of omission of the defendant and the damage which the plaintiff has suffered". *Prosser and Keeton*, § 41 at 263.

[4] E.g, In re Kim, 163 B.R. 157 (9th Cir. BAP 1994) aff'd. 62 F.3d 1511 (9th Cir. 1995); In re Drehsen, 190 B.R. 441 (M.D. Fla. 1995); In re Foley, 156 B.R. 645 (Bankr. D.N.D. 1993); In re O'Connor, 149 B.R. 802, 804 (Bankr. E.D. Va. 1993)("since nondischargeability on the grounds of false financial statement is in the nature of fraud, bankruptcy case law adopts the element of proximate result from tort-based fraud"); In re Graham, 122 B.R. 447 (Bankr. M.D. Fla. 1990); In re Hott, 99 B.R. 664 (Bankr. W.D. Pa. 1989); In re Richards, 81 B.R. 527, 530 (Bankr. D. Minn. 1987)("It has been judicially recognized, and there is evidence of Congressional intent, that fraudulent conduct which produces no adverse consequences to the victim, should not result in a judgment of nondischargeability"); In re Anzman, 73 B.R. 156 (Bankr. D. Colo. 1986); In re Blatz, 37 B.R. 401 (Bankr. E.D. Wis. 1984).

Two Courts of Appeals and the court below have reached the opposite conclusion. These courts found that a debt can be nondischargeable even if the creditor suffered no harm as a proximate result of the debtor's misrepresentation. Matter of McFarland, 84 F.3d 943, 947 (7th Cir. 1996) ("the text of § 523(a)(2)(B) contains no damage or detriment requirement");[5] Matter of Norris, 70 F.3d 27, 29 n.6 (5th Cir. 1995) (rejecting proximate causation requirement urged by the debtor); In re Goodrich, 999 F.2d 22, 26 (1st Cir. 1993) ("detriment or damage...is not required for nondischargeability").[6] See also In re Gerlach, 897 F.2d

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[5] Although the court purports to identify two causation requirements in the statutory language, McFarland at 946, by rejecting a damage or detriment element, the court essentially rejects any known concept of proximate cause. If no detriment to the creditor need be shown, the court is left with a concept of proximate cause without an effect. For this reason, the only reasonable reading of McFarland is that it rejects analysis of whether a debtor's false financial statement is the proximate cause of the creditor's loss.

[6] See note 5, supra.

1048, 1051 (10th Cir. 1990)(statutory language under § 523(a)(2)(A) "only requires that an objecting creditor prove an extension of credit was "obtained by" fraud for the debt to be excepted from discharge").[7]

For these courts, the debtor's conduct need not have been the proximate cause of a loss to the creditor. They read the statutory language "to the extent obtained by" a false financial statement to mean only that the false financial statement cause the renewal, extension or refinancing of credit -- not that it caused a material change in position resulting in a loss. See Goodrich, 999 F. 2d at 25; Norris, 70 F.3d at 29 n.6.[8]

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[7] Gerlach was presumably overruled by Field v. Mans, 116 S.Ct. 437, 133 L.Ed. 2d 351 (1995) which makes clear that § 523(a)(2)(A) incorporates elements of common law fraud.

[8] These courts do not explain why the statute does not simply say "obtained by" rather than "to the extent obtained by". They thus render the words "to the extent" superfluous in violation of the norms of statutory construction and the express legislative history discussed below.

The disagreement among the Circuits regarding the elements of dischargeability under section 523(a)(2)(B) should be resolved by the Supreme Court in favor of the petitioner's position. It makes no sense to create a cause of action for false statements (or for any action based in tort) for parties whose damages were not proximately caused by the conduct of the defendant.[9] Moreover, as discussed below, Congress clearly did not intend to do so in the case of § 523(a)(2). If this case is not heard by this Court, bankruptcy courts within different circuits will continue to reach conflicting and often incongruous decisions regarding dischargeability of debts.

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[9] See Field v. Mans, 116 S.Ct. at 442-443 (common sense would balk at barring discharge for misrepresentations which have no effect on a creditor's decision).

II. THE DECISION OF THE SEVENTH CIRCUIT IS INCORRECT AND WILL RESULT IN OUTCOMES AT VARIANCE WITH THE PLAIN MEANING OF THE STATUTE. THE DECISION ALSO IGNORES EXPRESS LEGISLATIVE HISTORY CONCERNING THE PRECISE SITUATION AT ISSUE IN THIS CASE.

McFarland, Norris, and Goodrich ignore three sources in the statutory language which lead to a conclusion that Congress intended to require that a false financial statement proximately cause harm to the creditor. First, there is the express requirement that the statement be "materially false". 11 U.S.C. § 523(a)(2)(B)(i). Any misstatement is immaterial if it is not proximate cause of the creditor's loss. W. Keeton, D. Dobbs, R. Keeton, & D. Owen, *Prosser and Keeton on Torts*, § 110, p. 767 (5th Ed. 1984). Second, there is an express "reasonable reliance" requirement. 11 U.S.C. § 523(a)(2)(B)(iii). Evidence of reliance is closely linked in the common law of fraud to evidence of a change in position by the defrauded party to that

party's detriment. See generally, *Prosser and Keeton*, §§ 108, 109, pp. 749-764. Third, and most importantly, debts are nondischargeable under the statute only "to the extent obtained by" a false financial statement. 11 U.S.C. § 523(a)(2)(B). The only reasonable interpretation of this language is that any part of a debt which is not obtained by means of a false statement is dischargeable, because the false statement was not the proximate cause of the creditor's loss.

Failure to find a proximate cause and detriment requirement in the statutory language is also contrary to the legislative history. Indeed, the legislative history anticipates the exact situation at issue in this case and states that the resolution would hinge on detriment to the creditor:

> [W]here the original financial statement is made under nonfraudulent conditions and the entire loan in addition to new money is advanced under a subsequent false financial statement, the entire loan is made under fraudulent conditions. This

> rule is sound as a matter of policy *because the creditor relies to his detriment* with respect to the entire amount advanced under the false financial statement. ... However, if the terms of the new agreement are identical to the old agreement with respect to the old money, then no new money was obtained by a false statement on which the creditor relied since the creditor's rights were unchanged; therefore only that portion of the false financial statement that applied to the new money would be nondischargeable.

Emphasis added. H.R. Rep. No. 595, 95th Cong., 1st Sess. 130 (1977), U.S. Code Cong. & Admin. News 1978, p. 5787, 6091 (1977). Contrary to the Seventh Circuit's analysis, the legislative history states outright that dischargeability in a refinancing scenario hinges on whether the false financial statement causes detriment to the creditor.[10]

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[10] The legislative statement also suggests that a change in maturity dates may be sufficient detriment to make the entire debt nondischargeable after refinancing. Here, although there was a change in maturity dates, the entire balance was earning interest at the same rate after refinancing. Thus, the creditor suffered no change in position on the earning capacity of the old money after refinancing. Also, the debtor

(continued...)

Additional legislative history makes the same point:

> In many cases, a creditor is required by state law to refinance existing credit on which there has been no default. If the creditor does not forfeit remedies or otherwise *rely to his detriment* on a false financial statement with respect to existing credit, then an extension, renewal or refinancing of such credit is nondischargeable only *to the extent of the new money advanced*; on the other hand, if an existing loan is in default or the creditor otherwise reasonably *relies to his detriment* on a false financial statement with regard to an existing loan, then the entire debt is nondischargeable under section 523(a)(2)(B). This codifies the reasoning expressed by the second circuit in In re Danns, 558 F.2d 114 (2d Cir. 1977).

Emphasis added. 124 Cong. Rec. H 11089 (Sept. 28, 1978), U.S. Code Cong. & Admin. News 1978, p. 6436, 6453 (1978) (statement of Rep. Edwards); 124 Cong. Rec. S 17406 (Oct. 6, 1978), U.S. Code Cong. & Admin.

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[10](...continued)
filed bankruptcy long before the maturity date on either the old or new loan. Finally, refinancing the old balance was the creditor's requirement in making the new loan -- not the debtor's request.

News 1978, p. 6505, 6522 (1978) (statement of Sen. DeConcini).

This case is indistinguishable from the Danns case codified by Congress. The Danns court stated:

> There is nothing in the legislative history of the 1960 amendments to indicate a congressional intent that a bankrupt should be penalized for more than simply the consequences of his fraud. Nor does it seem equitable for a bankrupt to be deprived of discharge on all his indebtedness to a particular creditor simply because a small portion of it was procured dishonestly.

Footnote omitted. Danns, 558 F.2d at 116 (referring to 1960 amendments to the Bankruptcy Act).

Here, state law did not require that the prior loan be paid off in the refinancing; the creditor itself did. If state action as the proximate cause of a loss to the creditor compels a conclusion that a debt is dischargeable, the creditor's own policy as the cause of

its loss should even more clearly lead to a conclusion in the debtor's favor.[11]

In summary, this case provides a good illustration of the analytical problem caused by the split in the Circuits. Ms. McFarland's arguably false financial statement only caused SDCU to lend her $3,500 dollars. The decision to finance any balance was compelled by SDCU's policies rather than by any action of Ms. McFarland. Nevertheless, the Seventh Circuit has found the entire debt to be non-dischargeable as would any other court which concludes that the debtor's conduct need not be the proximate cause of a loss to the creditor as a prerequisite to nondischargeability.

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[11] See Kelly v. Robinson, 479 U.S. 36, 47, 107 S.Ct. 353, 359, 93 L.Ed. 2d 298 (1986), citing Midlantic National Bank v. New Jersey Dept. of Environmental Protection, 474 U.S. 494, 106 S.Ct. 755 (1986) (In revising the bankruptcy law, Congress must enact clear language or expressly disapprove prior case law if it intends for it to be legislatively overruled). Here, the existing case law was expressly approved and there is no meaningful basis on which to distinguish the Bankruptcy Act case.

It is also significant that the First, Fifth, and Seventh Circuits read the "to the extent" language entirely out of the Code. If dischargeability were intended to be an all or nothing proposition, Congress could have simply made all debts "obtained by" a false financial statement nondischargeable. As described explicitly in the legislative history, by making debts nondischargeable only "to the extent obtained by" a false financial statement, Congress added an important causation prerequisite which courts must analyze on a case by case basis.

III. THE QUESTION AT ISSUE IS AN IMPORTANT QUESTION UNDER THE BANKRUPTCY CODE. RESOLUTION OF THIS ISSUE WILL ADVANCE THE RECENT EFFORTS OF THIS COURT TO MINIMIZE OPEN QUESTIONS ABOUT THE ELEMENTS OF CASES INVOLVING NONDISCHARGEABILITY FOR FRAUD UNDER THE CODE.

As illustrated by the number of bankruptcy, district court and court of appeals decisions cited in Part

I of this petition, a great deal of judicial time has been spent over the past 18 years giving content to the statutory language in § 523(a)(2)(B). Many of these cases are based on extension, renewal and refinancing of existing credit. To a large degree, that is because lenders like SDCU increasingly encourage their existing customers to refinance or renew credit because it is profitable business.

Extensions, renewals, and refinancings of credit create a multitude of opportunities for creditors to obtain new financial statements from existing customers. As this Court noted last term, creditors' requirements of proof to establish nondischargeability in cases under § 523(a)(2)(B) are more strict than for cases under § 523(a)(2)(A) because of Congressional concern about improper creditor use of financial statements. Field v. Mans, 116 S.Ct. at 446-447 citing H.R. Rep. No. 595, 95th Cong., 1st Sess. 130-131 (1977), U.S. Code Cong.

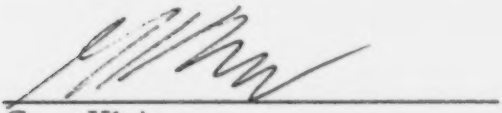
& Admin. News 1978, p. 5787, 6091 (1977). Resolution of this case in the debtor's favor is necessary to give effect to this important Congressional purpose.

In recent years, this court has taken a series of cases which have helped resolve disputed issues under 11 U.S.C. § 523(a)(2). In Grogan v. Garner, 498 U.S. 279, 111 S.Ct. 654, 112 L.Ed. 2d 755 (1991) the Court determined the standard of proof for cases under § 523(a)(2). In Field v. Mans, - U.S. -, 116 S.Ct. 437, 133 L.Ed. 2d 351 (1995), the Court resolved a disputed issue about the elements of a case under § 523(a)(2)(A). Given the state of the law and the split in the Circuits described here, it is equally important to delineate the scope of any causation and detriment requirement under § 523(a)(2)(B).

CONCLUSION

For the foregoing reasons, petitioner requests that this court grant certiorari in this case.

RESPECTFULLY SUBMITTED,



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APPENDIX A.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

SOUTH DIVISION
CREDIT UNION,
Plaintiff-Appellant,

v.

DOROTHY McFARLAND,
Defendant-Appellant.

No. 94 C 4613

Hon. Paul E. Plunkett
(93 A 1660; 93 B 18989)

JUDGMENT ORDER

This cause coming on to be heard for status from an appeal to the United States Court of Appeals for the Seventh Circuit and its decision dated May 23, 1996, reversing the judgment of this Court, and in accordance with the mandate of the United States Court of Appeals:

IT IS HEREBY ORDERED:

1. That the entire amount of the May 11, 1993, note is nondischargeable in full, in accordance with 11 U.S.C. § 523(a)(2)(B).

2. That judgment is entered in favor of the plaintiff and against the defendant in the amount of $8,712.28, plus costs.

DATE: July 10, 1996

ENTER:

/s/_____
JUDGE

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APPENDIX B.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT.

No. 95-1874

IN THE MATTER OF:

DOROTHY MCFARLAND,

Debtor-Appellee.

APPEAL OF: SOUTH DIVISION CREDIT UNION.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 94 C 4613—Paul E. Plunkett, *Judge*.

ARGUED JANUARY 3, 1996—DECIDED MAY 23, 1996

Before COFFEY, MANION, and KANE, *Circuit Judges*.

KANNE, *Circuit Judge*. South Division Credit Union filed an adversary complaint in a chapter 7 bankruptcy proceeding alleging the nondischargeability of the balance on a promissory note executed by the debtor, Dorothy McFarland. The bankruptcy court determined that only a fraction of the total balance was nondischargeable under the relevant statute, and the district court affirmed. *South Division Credit Union* v. *McFarland*, 179 B.R. 87 (N.D. Ill. 1995). The district court found that the statutory language requires only that the amount of addi-

tional credit extended to the debtor in such a transaction is non-dischargeable. This appeal followed, and it presents us with the question whether the discharge exception prescribed by 11 U.S.C. § 523(a)(2)(B) encompasses the entire amount of a loan whose proceeds are used in part to extinguish the debtor's obligation on a previous loan from the same creditor.

I

The material facts are undisputed. McFarland had been a longtime Credit Union customer when she executed a promissory note on May 29, 1991, in the amount of $7,669.97 with a maturity date of February 28, 1995. She consistently made timely payments on this note. On May 11, 1993, McFarland applied for a loan from the Credit Union in the amount of $9,257.17 and subsequently executed a promissory note for this amount. The loan secured by the May 1993 note comprised a disbursement of $3,500 to McFarland and the satisfaction of her obligation on the May 1991 note, which then had a balance of $5,757.17.

The record suggests that this was the typical method by which the Credit Union extended additional credit while simultaneously refinancing existing debt. McFarland executed five separate promissory notes between December 10, 1990, and May 11, 1993. We itemize the notes below using the terms that appear on the face of the notes:

Origination date	Loan amount	Disbursed to McFarland	Credited to account[1]	Maturity date
12/10/90	$6,948.54	$ 900.00	$6,048.54	07/09/94
02/13/91	$7,549.96	$ 835.00	$6,714.96	02/13/95
05/29/91	$7,669.97	$ 500.00	$7,169.97	02/28/95
05/05/92	$7,233.36	$1,000.00	$6,233.36	05/01/96
05/11/93	$9,257.17	$3,500.00	$5,757.17	05/01/98

[1] The sums classified as "credited to account" on each promissory note were devoted to discharging McFarland's obligations on the preceding promissory note.

The terms of these promissory notes demonstrate that the proceeds of each note were used to pay off whatever balance McFarland owed the Credit Union on the most recent note. The remaining sum represented the amount of additional credit that the Credit Union extended to her on the same terms as those covering the refinancing of her outstanding balance. The Credit Union disbursed the additional credit to McFarland in the form of cash payments. Each promissory note referenced the same member, account, and contract numbers and the same secured collateral of $300.00 that was contained in McFarland's account with the Credit Union.

McFarland applied for the May 1993 loan by providing the Credit Union with a financial statement that purported to list her assets and liabilities. She failed to include in that statement her liability as cosigner on a $7,000 promissory note to the Overland Bond Company (the "Overland note") and the fact that she owed the Internal Revenue Service $1,500. The Credit Union made the May 1993 loan because the incomplete information McFarland provided showed a debt-to-income ratio of 42 percent, below the Credit Union's limit of 45 percent. Had McFarland disclosed her liability on the Overland note or her debt to the IRS, the Credit Union would have calculated her debt-to-income ratio as exceeding 45 percent and denied her application. Had that occurred, the May 1991 note would have remained in force with a maturity date of February 28, 1995.

McFarland filed for liquidation under chapter 7 of the Bankruptcy Act of 1988, 11 U.S.C. § 701 *et seq.*, on September 8, 1993, in the Northern District of Illinois. At that time, the May 1993 note had an outstanding balance of $8,712.28. The Credit Union filed an adversarial complaint in the bankruptcy proceeding seeking a determination that the entire balance of $8,712.28 was nondischargeable pursuant to the fraud exception contained in 11 U.S.C. § 523(a)(2)(B). The bankruptcy court conducted a hearing on June 15, 1994, at which it heard

testimony from McFarland and Eileen Ivanauskas, collection administrator at the Credit Union. Immediately following the parties' closing arguments, the bankruptcy court ordered that $3,500 of the balance was nondischargeable pursuant to § 523(a)(2)(B).

The Credit Union appealed to the district court pursuant to 28 U.S.C. § 158(a), and the district court affirmed the bankruptcy court in a memorandum opinion and order dated March 9, 1995. 179 B.R. 87. The district court focused upon the statutory requirement that a debt be nondischargeable "to the extent obtained" by a materially false statement. It found that McFarland had obtained only the $3,500 additional credit by virtue of her false financial statement and that the Credit Union did not assume any risk on McFarland's existing balance of $5,757.17 when it used that portion of the loan proceeds to retire the May 1991 note.

II

In liquidation cases under Chapter 7, the court is required to grant qualified debtors discharges from debts except as provided by 11 U.S.C. § 523. *See* 11 U.S.C. § 727(b). In a nutshell, discharge operates to void a judgment predicated upon the debtors personal liability to the extent the judgment encompasses any portion of the discharged debt and also enjoins the commencement of any action seeking such a judgment. *See* 11 U.S.C. § 524. Discharge essentially places a debtor in a safe harbor with respect to discharged debt[s].

The Bankruptcy Code exclusively governs the determination of whether a debt is nondischargeable, *Brown* v. *Felsen*, 442 U.S. 127, 129-30, 99 S.Ct. 2205, 2208-09 (1979), and the exceptions to discharge are set out at 11 U.S.C. § 523. The statutory provision at issue concerns the discharge exception for debts incurred through materially false written statements:

> A discharge under section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt — . . .
>
> (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained, by — . . .
>
> (B) use of a statement in writing —
>
> (i) that is materially false;
>
> (ii) respecting the debtor's or an insider's financial condition;
>
> (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
>
> (iv) that the debtor caused to be made or published with intent to deceive. . . .

11 U.S.C. § 523(a)(2)(B).

The Bankruptcy Code also describes procedures for resolving controversies concerning [non]dischargeability. Either the creditor or the debtor may file a complaint under § 523(c), which requires the district court[2] to provide notice and a hearing to determine whether a debt qualifies for the exception described in § 523(a)(2)(B). 11 U.S.C. § 523(c); BANKR. R. 4007. Debts that might otherwise qualify under § 523(a)(2)(B) are presumed dischargeable unless a creditor files a complaint and proves otherwise. 3 COLLIER ON BANKRUPTCY ¶ 523.05B, at 523-18 (15th ed. Feb. 1996). The creditor bears the burden of proving

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[2] Following the Supreme Court's plurality opinion in *Northern Pipeline Constr. Co.* v. *Marathon Pipe Line Co.*, 458 U.S. 50, 102 S.Ct. 2858 (1982), the district courts retain "original and exclusive jurisdiction of all cases under title 11 [of the United States Code]," subject to the provisions of 28 U.S.C. § 1334(b). 28 U.S.C. § 1334(a). The district court is empowered to refer proceedings under Title 11 to a bankruptcy judge from the district pursuant to 28 U.S.C. § 157(a). The bankruptcy court is therefore an adjunct of the district court.

by a preponderance of the evidence that the debt meets the statutory exception requirements. *Grogan* v. *Garner*, 498 U.S. 279, 291, 111 S.Ct. 654, 661 (1991); *In re Thirtyacre*, 36 F.3d 697, 700 (7th Cir. 1994).

Because this appeal concerns the district court's legal interpretation of § 523(a)(2)(B), our review is *de novo*. *In re Sheridan*, 57 F.3d 627, 633 (7th Cir. 1995). Certain courts have construed the statutory exceptions to discharge "in favor of the debtor" and have required that reasons supporting nondischargeability "be real and substantial, not merely technical and conjectural." *In re Tully*, 818 F.2d 106, 110 (1st Cir. 1987) (citation omitted). *See also In re Miller*, 39 F.3d 301, 304 (11th Cir. 1994) (collecting authority). However, this interpretive gloss, whatever its pedigree in the statute's legislative history, is insufficient to support a construction of § 523(a)(2)(B) that does not give due regard to the statute's plain meaning, which is the starting point for our inquiry. *See In re Witkowski*, 16 F.3d 739, 745 (7th Cir. 1994).

III

There are two causation requirements for nondischargeability of "an extension, renewal, or refinancing of credit" under § 523(a)(2)(B). The first is set forth in the "to the extent obtained by" language. The second causation element is incorporated in the requirement that the creditor rely on the materially false statement. *See in re Goodrich*, 999 F.2d 22, 24 (1st Cir. 1993).

In our analysis and review, we cannot focus only on the former requirement and ignore the plain meaning of the language immediately preceding it. Such an approach would offend the venerable canon that one must read a statute as a whole and give meaning to each of its constituent parts. *See United States* v. *Nordic Village, Inc.*, 503 U.S. 30, 35-36, 112 S.Ct. 1011, 1015 (1992); *Trustees of the Chicago Truck*

Drivers, Helpers and Warehouse Workers Union (Independent) Pension Fund v. *Leaseway Transp. Corp.*, 76 F.3d 824, 828 (7th Cir. 1996).

Read as a contextual whole and as applicable to the facts of this case, § 523(a)(2)(B) provides that nondischargeability is not available for ". . . an extension, renewal, or refinancing of credit, to the extent obtained by . . . use of a written statement . . . that is materially false."

The May 1993 note was, in part, a refinancing of the May 1991 note: the proceeds of the McFarland's May 1993 note were used to pay off her existing debt on the May 1991 note. *See* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1908 (1986) (defining refinance); BLACK'S LAW DICTIONARY 1281 (6th ed. 1990) (same). The May 1993 note extended the maturity date on the balance of the May 1991 note and concomitantly increased McFarland's financial obligation on that balance by imposing the additional interest that would accrue over the term of the note. Absent compelling evidence to the contrary, we assume that words in a statute carry the weight of their ordinary contemporary, and common meaning. *Pioneer Inv. Serv. Co.* v. *Brunswick Assoc. Ltd. Partnership*, 507 U.S. 380, 388, 113 S.Ct. 1498, 1495 (1993). The ordinary and common meaning of "refinance" in the context of § 523(a)(2)(B) requires that the portion of the May 1993 note constituting the balance previously due on the May 1991 note be nondischargeable.

It is clear that the Credit Union relied upon McFarland's application not only in extending her $3,500 in additional credit but also in refinancing her existing debt. The Credit Union's collections administrator testified that the Credit Union would not have written the May 1993 loan had it known of McFarland's liability on the Overland note and indebtedness to the IRS.

One final point should be noted. The language of the district court's order suggests that its analysis was premised upon a

conclusion that the Credit Union was no worse off than it would have been had it not refinanced McFarland's debt on the May 1991 note prior to her filing under Chapter 7. This implies the existence of a detriment requirement in the statute, but the text of § 523(a)(2)(B) contains no damage or detriment requirement, and the courts are not empowered to add one. *See In re Norris*, 70 F.3d 27, 29 n.6 (5th Cir. 1995) (noting that such a requirement would be surplusage in light of the two causation requirements in § 523(a)(2)(B)). For those who would resort to legislative history to reach this conclusion, the First and Tenth Circuits have concluded that the history attending the enactment of § 523(a)(2)(B) confirms our [and their] plain reading of the statute. *See Goodrich*, 999 F.2d at 25-27; *In re Gerlach*, 897 F.2d 1048, 1051 & n.2 (10th Cir. 1990). We do not reproduce their discussions here, for there is no need to examine legislative history where the words of a statute are clear. *Barnhill* v. *Johnson*, 503 U.S. 393, 401-02, 112 S.Ct. 1386, 1391 (1992); *United States* v. *Hudspeth*, 42 F.3d 1015, 1022 (7th Cir. 1994) (en banc), *cert. denied*, 115 S.Ct. 2252 (1995).

IV

The Credit Union reasonably relied upon McFarland's materially false written statement in refinancing her balance of $5,757.17 on the May 1991 note and in extending her additional credit in the amount of $3,500. In accordance with § 523(a)(2)(B) the May 1993 note is nondischargeable in full.

The judgment of the district court is REVERSED and this case is REMANDED to the district court so that it may enter judgment consistent with this opinion.

A true Copy:
Teste:

_____

Clerk of the United States Court of Appeals for the Seventh Circuit

APPENDIX C.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

SOUTH DIVISION
CREDIT UNION,
Plaintiff-Appellant,

v.

DOROTHY McFARLAND,
Defendant-Appellant.

JUDGMENT IN A CIVIL CASE

CASE NO: 94C 4613
(93 A 1660)
93 B 18989

☐ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that the district court affirms the bankruptcy judge's decision that only the $3,500 loaned by South Division Credit Union to Dorothy McFarland on the basis of the fraudulent May 1993 loan application is non-dischargeable.

March 9, 1995
Date

H. STUART CUNNINGHAM
Clerk

Theresa B. Kinney
(By) Deputy Clerk

APPENDIX D.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

SOUTH DIVISION
CREDIT UNION,
Plaintiff-Appellant,

v.

DOROTHY McFARLAND,
Defendant-Appellant.

No. 94 C 4613
Hon. Paul E. Plunkett

(93 A 1660;
93 B 18989)

MEMORANDUM OPINION AND ORDER

Plaintiff-appellant South Division Credit Union (the "Credit Union") appeals from the decision of the bankruptcy court that it may recover only the $3,500 it lent to defendant-appellee and debtor Dorothy McFarland ("McFarland") on the basis of a false financial statement, rather than the entire amount McFarland owed to the Credit Union. For the reasons set forth below, we affirm the decision of the bankruptcy court.[1]

Facts

The facts in this case are undisputed. McFarland was a member of the Credit Union for twenty-four years and obtained a number of loans there. On May 29, 1991, McFarland obtained a loan in the amount of several thousand dollars that was scheduled to mature on February 28, 1995. McFarland always

[1] On December 2, 1994, we informed the parties that we were affirming the bankruptcy court and that this memorandum opinion and order would follow. We also informed them that the time for appeal would not begin to run until this opinion was issued.

made timely payments on the loans she obtained from the Credit Union. In 1993, those payments were made by automatic payroll deductions.

On May 11, 1993, McFarland applied for a new loan in the amount of $3,500 in order to fix the roof on her house. She still owed approximately $5,700 on the 1991 loan. In the 1993 application, McFarland failed to disclose that she had co-signed a $7,000 note held by the Overland Bond Company on behalf of her brother, and that she owed the Internal Revenue Service $1,500 in taxes from 1990.

In considering all loan applications, the Credit Union uses a debt-to-income ratio limit of forty-five percent. A loan applicant whose debt-to-income ratio is above forty-five percent will not receive a loan, regardless of past credit history. The Credit Union applied this ratio to McFarland's 1993 application. Through the omission of the Overland Bond Company indebtedness and the Internal Revenue Service indebtedness, McFarland's debt-to-income ratio was forty-two percent.[2] As a result, her 1993 loan application was approved. If those debts had been disclosed, her debt-to-income ratio would have been higher than forty-five percent, and the Credit Union would have denied her loan application.

It is also the practice of the Credit Union to consolidate into one loan the monies lent to a member. Thus, in May 1993, the Credit Union gave McFarland a new loan in the amount of $9,257.17, which represented the amount she still owed on the 1991 loan plus the additional $3,500. The new loan was scheduled to mature on May 1, 1998. The 1991 loan was cancelled.

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[2] There is no evidence that McFarland knew that the Credit Union employed a debt-to-income ratio of forty-five percent, or that she knew she would fall below that limit if she omitted the Overland Bond Company and Internal Revenue Service debts. However, it is undisputed that McFarland knew of and failed to disclose those debts when she applied for the 1993 loan.

McFarland filed a Chapter 7 bankruptcy petition on September 8, 1993. At that time, she owed the Credit Union $8,712.28. The Credit Union filed an adversary complaint objecting to the discharge of any portion of the monies still owed by McFarland. The bankruptcy court held a trial on June 15, 1994, at which McFarland and the Credit Union's collection administrator testified. At the close of the trial, the bankruptcy judge ruled from the bench that only the $3,500, representing the "new money" loaned on the basis of the fraudulent loan application, was non-dischargeable. The Credit Union appeals from that ruling.

Discussion

Under 28 U.S.C. § 158(a), we may hear appeals from final judgments, orders, and decrees of bankruptcy judges in this district. We review the bankruptcy court's findings of fact for clear error and its conclusions of law *de novo*. *Matter of UNR Indus., Inc.*, 986 F.2d 207, 208 (7th Cir. 1993). The parties agree that the only issue before us is one of law.

Section 523 sets forth a number of instances in which a debt may not be discharged. Section 523(a)(2)(B) prohibits discharge where the debt is for:

> (2) money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—
>
> . . . .
>
> (B) use of a statement in writing—
>
> (i) that is materially false;
>
> (ii) respecting the debtor's or an insider's financial condition;
>
> (iii) on which the creditor to whom the debtor is liable for such money, property, services or credit reasonably relied; and

> (iv) that the debtor caused to be made or published with intent to deceive . . .

11 U.S.C. § 523(a)(2)(B) (1993). Here, it is undisputed that McFarland's 1993 loan application meets all the requirements of this subsection. The bankruptcy judge held that only the $3,500 of "new money" loaned in 1993 was non-dischargeable because those were the only funds the Credit Union had loaned to McFarland in reliance on the false financial statement. The Credit Union argues, as it did before the bankruptcy court, that the entire amount of $8,712.28 should be non-dischargeable under section 523(a)(2)(B) because it issued McFarland a new loan in 1993 and cancelled her 1991 loan. McFarland, of course, disagrees.[3]

As the parties correctly note, this issue has never been addressed by the Seventh Circuit, although three circuits have dealt with similar cases. In *In re Goodrich*, 999 F.2d 22 (1st Cir. 1993), the First Circuit held that where the creditor showed that it would not have renewed an existing loan that had come due or advanced additional money but for the debtor's false financial statement, the entire amount of the debt was non-dischargeable. *Id.* at 27. Similarly, in *In re Gerlach*, 897 F.2d 1048 (10th Cir. 1990), the Tenth Circuit held that where a John Deere dealership repeatedly submitted sham customer financing applications to obtain provisional credit from the manufacturer, the debt was non-dischargeable. The court noted:

> If a creditor can prove by clear and convincing evidence that the debtor obtained credit through fraud, the court should declare the debt non-dischargeable in an amount which it can reasonably estimate as obtained by the fraud. And a debt is "obtained by"

[3] McFarland does not appeal from the bankruptcy court's ruling that the $3,500 loaned in 1993 is non-dischargeable.

> fraud if the fraud is a substantial factor in the creditor's decision.

Id. at 1052. And, in *In re Siriani*, 967 F.2d 302 (9th Cir. 1992), the Ninth Circuit held that the creditor had to show that the debtor's fraud proximately caused its injuries and that, as a result of the fraud, it gave up valuable collection remedies on the original debt that subsequently became worthless, in order to recover the entire amount of the debt. **Id.** at 306.

The Credit Union characterizes these three decisions as evidencing a split in the circuits, for it says the First and Tenth Circuit have held that the entire debt is non-dischargeable where "new money" was obtained by fraud, and that the Ninth Circuit has limited non-dischargeability to the "new money." We disagree, as does McFarland, with both this characterization and its applicability to this case. Both *Gerlach* and *Goodrich* are distinguishable, for they clearly involve the renewal of loans that had come due or the extension of additional credit.

For our purposes, the operative language, in section 523(a)(2)(B) is that the debt is non-dischargeable "to the extent obtained" by a false financial statement. Here, the undisputed evidence presented at trial showed that McFarland obtained only the additional $3,500 loaned in May 1993 by means of the fraudulent loan application. We agree with the bankruptcy judge that the Credit Union's practice of closing existing loans and extending new loans constituted a "paper transaction," and that the Credit Union did not take a new credit risk on the unpaid balance of the 1991 loan on the basis of the fraudulent 1993 loan application. (Tr. at 50.) Only the $3,500 was obtained by means of the false financial statement, and hence, only that debt is non-dischargeable. To conclude otherwise would render the "to the extent obtained" language of section 523(a)(2)(B) meaningless.

Conclusion

For the foregoing reasons, we affirm the bankruptcy judge's decision that only the $3,500 loaned by South Division Credit Union to Dorothy McFarland on the basis of the fraudulent May 1993 loan application is non-dischargeable.

ENTER:

/s/_____
UNITED STATES DISTRICT JUDGE

DATED: March 9, 1995

APPENDIX E.

client was always there with the money. She was on payroll deduction. She approached them about the loan.

Your honor, I ask that this be dismissed.

THE COURT: I am going to enter judgment in favor of the plaintiff to the extent of $3,500. I find that money was obtained to that extent, to the extent of $3,500 but not to any greater extent, by a statement that was in writing that was materially false given the debtor's overall circumstances, total debt of $8,500 is material. The writing did respect the debtor's financial condition and the creditor, the plaintiff here, did and could reasonably rely upon that statement in making the loan. The evidence is unrebutted that the debt-to-loan ratio, the limit is 45 percent and these loans if disclosed would have as a mathematical matter put her over that limit regardless of what else was in the record or the payment history of the debtor according to the unrebutted evidence. That alone would have caused the credit union to deny this new $3,500 loan.

The intent to deceive is probably the most difficult issue here, but it is clear that she was fully aware of the Overland obligation. It was highlighted in her mind and she failed to disclose that obligation. It is not clear that she knew about the plaintiff's policies, but the fact that she knew about the obligation and needed the

[57]

money and failed to disclose that obligation and that she would not have obtained the money if she had disclosed that obligation was enough to at least create an inference of an intent to deceive. The standard of proof here is preponderance of the evidence. I think based on that

standard of proof, I have to find for the plaintiff but only in the amount of $3,500.

Submit a draft order.

(Which were all the proceedings had in the above-entitled matter as of June 15, 1994)

I, BARBARA A. CASEY, DO HEREBY CERTIFY THAT THE FOREGOING IS A TRUE AND ACCURATE TRANSCRIPT OF PROCEEDINGS.

/s/_____